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Virgin Islands Water & Power Authority

Update following downgrade to Caa2; negative outlook

Summary

The credit profile of the Virgin Islands Water and Power Authority ("VI WAPA", senior electric system revenue bonds Caa2, subordinated electric system revenue bonds Caa3, negative) is constrained by an unsustainable capital structure with very tight liquidity, high debt load including a substantial unfunded pension liability, the increased frequency of power outages, reducing the reliability of the electric system, high electric rates, and chronic challenges facing the economy. The credit profile considers also the credit profile of the Government of the US Virgin Islands (issuer rating Caa3 stable).

Nevertheless, the credit profile recognizes recent positive developments. These include for instance that the government has paid down overdue receivables at the end of July 2019, FEMA grants have provided funds to invest in the hardening of the transmission & distribution system against future hurricanes, the New York Power Authority is assisting VI WAPA in finding the root cause of the recent power outages, and financial reporting has been improving. Overall management and governance practices remain weak and the fiscal year 2018 audit is still pending.

Positively, bondholders for rated senior and subordinate debt benefit from a fully cash funded debt service reserve fund for both the senior (around $11 million) and subordinated debt (around $4 million), and VI WAPA continues to monthly fund the required principal and interest into the debt service fund for both the senior and subordinated debt, consistent with the terms of the indenture waterfall.

The Caa3 subordinate lien electric system revenue bond rating reflects the junior position of these securities relative to the senior lien electric system revenue bonds.

Credit strengths

» Reduction in overdue government receivables as of the end of July 2019

» FEMA and Housing and Urban Development (HUD) grants have provided funds to invest in the hardening of the transmission & distribution system against future hurricanes and the acquisition of new, efficient generating units and increased renewable energy projects

» Rate structure includes automatic recovery mechanism

» Increased transparency to bondholders

» Debt service reserve fund for rated senior and subordinated bonds

Credit challenges

» System reliability and recent frequent power outages

» Retail electricity rates are the highest among US states and territories

» Customer peak demand and revenue collections remain below pre-hurricane levels

» Very limited liquidity resources, overdue supplier trade payables and high leverage

» Execution of various capital projects will require management resources and good control of costs

» 2018 audit has not been released yet

Rating outlook

The negative outlook considers VI WAPA's very weak liquidity, very high retail electric rates, growth challenges within the economy and the recent high frequency of power outages, reducing the reliability of the electric system.

Factors that could lead to an upgrade

» Improvement in the authority's liquidity profile

» Improved reliability of the electric system

» Rate increases supporting improved cost recovery and translating into improvement of financial metrics with Moody's total fixed charge coverage ratio improving to 1.0x.

» Improvements in the credit quality of the Government of the US Virgin Islands

Factors that could lead to a downgrade

» Continued deterioration of VI WAPA's liquidity profile and financial metrics, threatening the long-term sustainability of the authority

» Deterioration in the credit quality of the Government of the US Virgin Islands

» Debt restructuring and/or prospects for recovery rate worsen

Key indicators

Exhibit 1

Virgin Islands Water and Power Authority	2012	2013	2014	2015	2016	2017
Operating Revenue ($'000)	333,404	341,158	323,202	270,310	224,310	243,800
Debt Outstanding ($'000)	293,717	284,113	279,746	266,575	265,786	443,693
Debt Ratio (%)	87.1	89.4	81.8	77.3	86.6	99.1
Total Days Cash on Hand (days)	32	29	32	33	13	17
Fixed Obligation Charge Coverage (if applicable)(x)	0.80	1.07	0.98	0.83	1.13	0.79

Fixed Obligation Charge Coverage in 2015 would be -0.13x including deferred pension expenses recognized in the authority's operating expenses. Total days cash on hand in 2016 and 2017 only includes unrestricted cash balance on balance sheet and not any other restricted reserves as these are deemed not to be readily available. All credits metrics are calculated as defined and adjusted by Moody's Investors Service.
Source: Audited financial statements VI WAPA electric system, Moody's Investors Service.

Profile

VI WAPA is an independent governmental agency of the U.S Virgin Islands and was created in 1964. Its electric system is a monopoly provider of electric service to close to 50,000 customers on St. Thomas, St. Croix, St. John, Water Island and Hassel Island. Unlike the majority of publicly owned entities, the rates of both the electric and water systems are regulated by the Public Services Commission (PSC) of the U.S. Virgin Islands. The water and the electric system are independently financed with separate liens on net revenues securing the outstanding debt of each system. We only rate debt of the electric system and the authority provides separate accounting for each system.

Detailed credit considerations

Revenue Generating Base

Uncertainty around recovery of the Virgin Islands economy

VI WAPA is tasked with maintaining a reliable electric system in a territory that has been frequently exposed to hurricanes. While the authority is critical to the economy as a monopoly electricity provider it is also challenged by operating within an island economy that is still recovering from the last two hurricanes and is constrained by relatively sluggish economic growth, a high net pension liability, high unemployment and a narrow local economy which is largely dependent on tourism.

The territory's economy was in decline prior to the hurricanes of September 2017. As a result of the closure of the Hovensa oil refinery in 2012 and weak performance in the tourism sector, nominal GDP declined at a compounded annual rate of 1.2% from 2012 to 2017. Population decreased from 115,852 in 2008 to 96,815 in 2017, while employment fell from 49,589 to 42,418 over the same period. Visitor arrivals have recovered since the hurricanes but remain below historical levels.

Government finances have been severely strained. Moody's confirmed the issuer rating assigned to the Government of the US Virgin Islands at Caa3 with a stable outlook on September 19, 2019. The hurricanes resulted in an interruption in tax revenues and added storm-related expenditures, further straining the government's financial position. While the receipt of grants and loans from the federal government in response to the hurricanes and a surge in tax revenues associated with local rebuilding efforts have provided some near-term relief, the general fund could return to structural imbalance in coming years.

Timely cost recovery constrained by high retail rates and weak economy

The total residential electric rate on the Virgin Islands is around 40.32 cents/kWh. A temporary surcharge for additional leased generating units was approved earlier this year but the authority's retail rates are the highest among US states and territories, and resistance against future rate increases could increase if VI WAPA is unable to restore the reliability of the electric system in the near term, particularly given the chronic economic challenges.

Electric rates are regulated by the Virgin Island Public Services Commission (PSC). VI WAPA's rate structure includes numerous automatic cost recovery mechanisms that flow through its LEAC and are adjusted regularly. The largest component of the LEAC is the projected cost for fuel (including purchased power) but it also includes such things as the cost of financing related to fuel expense and the ability to recover the cost of deferred fuel. Since 2015, the LEAC is adjusted semi-annually rather than quarterly. Base rate hearings are conducted as needed but not less than once every 5 years. The LEAC per kilowatt hour (kWh) surcharge fee is currently $19.25 cents.

FEMA and HUD grants allow VI WAPA to invest in the resiliency of the electric system

FEMA and HUD grants have provided funds to invest in the hardening of the transmission & distribution system against future hurricanes and the acquisition of new, efficient generating units and increased renewable energy projects.

By the beginning of March 2018, VI WAPA had restored power to all eligible customers, substantially supported by the assistance of nearly 1,000 off-island linemen, local contractors and VI WAPA personnel and monetary assistance from FEMA. FEMA Public Assistance has reimbursed VI WAPA for around $400 million for emergency response efforts under the FEMA Public Assistance Grant Program.

In addition, VI WAPA has received grants from FEMEA under the Hazard Mitigation Grant Program with a reduced required local share of 10% of eligible costs. VI WAPA expects to meet the local share requirement with funding from grant money under the US Department of Housing and Urban Development grant provided to the Government of the Virgin Islands.

The additional grants allow VI WAPA to focus on capital projects that are aimed at increasing the resiliency of the electric transmission and distribution system against future hurricanes by replacing wooden poles with composite poles and bringing critical transmission lines underground. Approved mitigation projects are around $613 million, of which $200 million have been spent.

The various capital projects will be executed over the next few years and a successful execution on time and on budget will require management's attention and resources. In total, funds obligated by FEMA total $1 billion.

Exposure to high outstanding government receivables has been reduced end of July 2019

Outstanding government receivables are mostly driven by receivables for street lighting costs and receivables from the hospitals. The government recently paid down overdue outstanding receivables. As of end of July 2019, the administration paid all prior years and current year bills owed to VI WAPA by central government agencies and owed by the two hospitals as well as the VI Waste Management Authority. However, it has to be seen if the government and the hospitals will remain current on their bills on a sustained basis.

Financial Operations and Position

LIQUIDITY

VI WAPA's liquidity profile remains very weak. As of July 30, 2019, VI WAPA had no unrestricted cash on balance sheet and was using overdraft facilities ($35.8 million as of July 30, 2019) to manage working capital. The two credit lines remain fully drawn and outstanding amounts are around $27 million.

VI WAPA has restricted cash of $5.8 million and restricted investments of $29.9 million which include the debt service fund and the debt service reserve fund. Total outstanding government receivables amounted to around $28 million as of end of July 2019 (of which $11.7 million were reported as non-current).

Debt and Other Liabilities

Exhibit 2

Outstanding debt - Virgin Islands Water and Power Authority

Debt Description - Electric System Senior Revenue Bonds	Outstanding ($'000)	Financial Maturity	Rating
Series 2003A	36,355	7/1/28	Caa2
Series 2010B	6,085	7/1/22	Caa2
Series 2010C	37,330	7/1/35	Caa2
Series 2012A	11,720	7/1/21	Caa2
Rural Utilities Service Note (RUS Loan)	11,839	1/1/35	NR
Total senior bond debt	**103,329**		
Debt Description - Electric System Subordinate Revenue Bonds	**Outstanding ($'000)**	**Financial Maturity**	**Rating**
Series 2007A	57,585	7/1/31	Caa3
Series 2012C	28,815	7/1/22	Caa3
Total subordinated debt	86,400		
Total senior and sub bond debt:	**189,729**		
Electric Senior Bond Anticipation Notes 2017A	14,765	7/1/21	NR
Electric Senior Bond Anticipation Notes 2018	33,960	7/1/20	NR
Other debt obligations as of July 31, 2019			
VITOL obligation - Propane project	136,159		
Subordinated credit lines and overdraft	63,007		
Obligations to Water System	106,266		

Source: VI WAPA, Moody's Investors Service.

VI WAPA faces increased refinancing risk over the next several years as nearly 40% of its senior and subordinated debt matures through 2022, some of which includes bullet or balloon obligations needing to be refinanced.

Positively, bondholders for rated senior and subordinate debt benefit from a fully cash funded debt service reserve fund for both the senior (around $11 million) and subordinated debt (around $4 million), and VI WAPA continues to monthly fund the required principal and interest into the debt service fund for both the senior and subordinated debt, consistent with the terms of the indenture waterfall.

VI WAPA has approximately $238 million in senior and subordinated electric system revenue debt and Bond Anticipation Notes. We note that the Bond Anticipation Notes 2017A have a conversion feature built in and VI WAPA estimates that cash in an escrow account will be sufficient to retire these notes at maturity. VI WAPA also expects to extend the 2019 Bond Anticipation Notes.

In addition, VI WAPA has other financial obligations such as overdraft and credit lines and an obligation to VITOL in the amount of $136 million for the LPG conversion.

Debt service is estimated to be around $24 million over the next few years, excluding interest on the Community Disaster Loan or the working capital credit lines. Principal payments are due July 1 of each year and interest is paid semiannually on January 1 and July 1 of each year.

VI WAPA's senior lien electric system revenue bonds are secured by a pledge of net electric revenues and certain other funds as defined in the bond resolution (water revenues are not pledged). The senior electric system revenue bonds have a debt service fund requirement equal to the lesser of (i) 10% of aggregate bond proceeds, (ii) maximum aggregate annual debt service or (iii) 125% average aggregate annual debt service.

The subordinate lien electric system revenue bonds rank behind the senior lien electric system revenue bonds and have a debt service reserve requirement equal to the lesser of 50% multiplied by (i) 10% of aggregate bond proceeds, (ii) maximum aggregate annual debt service or (iii) 125% average aggregate annual debt service. The subordinate lien electric system revenue bonds rank senior to any interest and principal on the authority's outstanding credit lines.

The unrated Bond Anticipation Notes do not benefit from a debt service reserve fund requirement and principal payments on these are subordinated to the rated senior and subordinated bonds.

VI WAPA's working capital credit lines are subordinated to senior lien and subordinated debt and tend to be fully drawn. These credit lines have been renewed in the past on an annual basis.

DEBT-RELATED DERIVATIVES

No debt-related derivatives.

PENSIONS AND OPEB

Exposure to High Pension Liabilities

The Virgin Islands' government employees' retirement system has an extremely large unfunded liability. As of September 30, 2017, the GAAP-basis net pension liability for the system was $4.4 billion. System assets are projected to be depleted by 2023 or sooner. Upon insolvency, projected contributions will cover only about half of projected benefits and expenses.

VI WAPA's employees participate in the Employees' Retirement System of the Government of the Virgin Islands (GERS), a cost-sharing, multiple-employer, defined benefit system administered by the board of GERS. The electric system's share in the adjusted net pension liability is close to $275 million (unaudited June 2019 monthly report). VI WAPA also provides certain post-employment health care benefits (OPEBs) to retirees under a health insurance plan. The benefits are extended at the discretion of VI WAPA which may modify terminate or adjust premiums as circumstances change. The accrued net OPEB liability amounts to $58.4 million as of June 30, 2019.

Management and Governance

The authority's management and governance practices are weak, evidenced by a history of filing financial statements with substantial lag, its lack of financial flexibility, late payment of trade payables, and limited practice of long-term financial planning. The audited financial statements for fiscal year 2018 (ending June 30, 2018) have not been filed yet.

On the positive side, management has increased its transparency and provides regular updates on the use of FEMA grants and quarterly/monthly updates on customers and financials through EMMA on an unaudited basis.

The authority is governed by a board of nine members which are appointed by the Governor of the Virgin Islands. Six members are appointed by the Governor, with the consent of the Legislature, for three year terms and three members are appointed by the Governor from his Cabinet.

Rating methodology and scorecard factors

The principal methodology used in this rating was US Public Power Electric Utilities With Generation Ownership Exposure published in August 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The scorecard indicated outcome for VI WAPA is a Caa2, in line with the assigned rating to the senior lien electric system revenue bonds.

Exhibit 3

Rating Factors - US Public Power Electric Utilities with Generation Ownership Exposure

Virgin Islands Water and Power Authority (VI WAPA)

	Subfactor	Score	Metric
1. Cost Recovery Framework Within Service Territory		B	
2. Wllingness and Ability to Recover Costs with Sound Financial Metrics		B	
3. Generation and Power Procurement Risk Exposure		B	
4. Competitiveness	Rate Competitiveness	B	
5. Financial Strength and Liquidity	a) Adjusted days liquidity on hand (3-year avg) (days)	Ba	21
	b) Adjusted Debt ratio (3-year avg) (%)	B	163%
	c) Adjusted Debt Service Coverage or Fixed Obligation Charge Coverage (3-year avg) (x)	B	0.92
Preliminary Grid Indicated outcome from Grid factors 1-5		B2	
		Notch	
6. Operational Considerations		-1	
7. Debt Structure and Reserves		-2	
8. Revenue Stability and Diversity		-1	
Grid Indicated Outcome:		Caa2	

Days cash on hand and fixed charge coverage ratios are based on Moody's average adjusted financial metrics for fiscal year 2015-2017. Adjusted debt ratio is based on fiscal year 2017. Audited financial statements for fiscal year 2018 have not been released yet.

Source: Audited financial statements electric system VI WAPA, Moody's Investors Service

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